Office of Chief Counsel
Internal Revenue Service
memorandum
CC:LM:NR:PNX:POSTF-126517-02
JWDuncan

date:

to: [redacted], Manager, Group [redacted]
Attn: [redacted] Team Coordinator

from: Associate Chief Counsel, Phoenix
LMSB:NR, Area 4

subject: [redacted] **Inc.**
Character of termination fee

This memorandum responds to your request for assistance dated June 5, 2002. This memorandum should not be cited as precedent.

ISSUES

1. Whether the termination fee paid by the taxpayer to [redacted] is deductible under § 162 as an ordinary and necessary business expense.

2. If such fee is not deductible under § 162, whether it constitutes a deductible loss under I.R.C. § 165.

CONCLUSIONS

1. The termination fee is not an ordinary and necessary business expense.

2. The termination fee is not a deductible loss under I.R.C. § 165.

FACTS

During [redacted], the taxpayer's CEO met with officials of [redacted] to discuss the possibility of a joint venture for the purpose of acquiring certain property. During these discussions, the parties determined that their goals might best be accomplished through a merger. After a period of investigation and negotiation, [redacted] and [redacted] entered into an Agreement and Plan of Merger on [redacted], and filed all required documents with the Securities and Exchange Commission (SEC).

20202

On [redacted], [redacted] announced its desire to acquire both [redacted] and [redacted], at which time the required documents were filed with the SEC. During [redacted], [redacted], a [redacted] Corporation, advised [redacted] in a letter of its desire to acquire [redacted].

At a special meeting of [redacted] directors on [redacted], the [redacted] Board passed a resolution stating that it was in the best interest of [redacted] and its shareholders to amend the merger agreement with [redacted] in order to permit the board to explore all strategic alternatives. We assume that the [redacted] Board was of similar mind, since [redacted] and [redacted] agreed to amend their merger agreement on [redacted]. On that date, [redacted] filed the required documents with the SEC in order to make a tender offer for [redacted] stock.

On [redacted], [redacted] terminated its merger agreement with [redacted], paying [redacted] a $[redacted] termination fee.

On [redacted], the [redacted] Board authorized a process under which all parties interested in acquiring [redacted] would submit bids by the close of business on [redacted] The Board also recommended that [redacted] shareholders reject the above-referenced offers from [redacted] and [redacted].

[redacted] and [redacted] submitted the only timely bids for [redacted]. At its meeting on [redacted], the [redacted] Board resolved that [redacted] enter into the merger agreement proposed by [redacted]. This agreement was executed on [redacted].

On [redacted], [redacted] substantially increased its tender offer for [redacted] shares. In response to this offer, the [redacted] Board recommended that its shareholders not tender their shares to [redacted]. After being advised that [redacted] would not improve its offer, the [redacted] Board agreed on [redacted] that [redacted] should attempt to negotiate an acceptable agreement with [redacted]. In addition, [redacted] and [redacted] were advised that the [redacted] Board would consider each company's best offer at its meeting on [redacted].

[redacted] responded by increasing its offer by an additional amount; [redacted] declined to increase its offer. The Board agreed at its [redacted] meeting to accept the [redacted] offer, and to terminate the [redacted] merger agreement effective [redacted]. On [redacted], [redacted] paid [redacted] a termination fee of $[redacted] pursuant to the terminated merger agreement. [redacted] and [redacted] completed their merger on [redacted] through the purchase of all [redacted] stock by a [redacted] subsidiary, followed by a merger of that subsidiary into [redacted].

On its [redacted] income tax return, [redacted] deducted the $[redacted] termination fee paid to [redacted]. You believe that this fee is not a deductible expense, and have requested our opinion on this matter.

DISCUSSION

1. Any discussion of this issue must start with a review of INDOPCO v. Commissioner, 503 U.S. 79 (1992). In that case, the taxpayer attempted to deduct investment banking fees related to the taxpayer becoming a subsidiary of another corporation in a friendly acquisition. In disallowing this claimed deduction, the Court noted that deductions are exceptions to the norm of capitalization, and are allowed only if there is a clear provision for them in the Code. Citing its opinion in Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345 (1971), the Court stated that to qualify for a deduction under I.R.C. § 162(a), an item must be paid or incurred during the taxable year, be for carrying on a trade or business, be an expense, be an ordinary expense, and be necessary. The Court further indicated that Lincoln Savings stands for the proposition that an expenditure that serves to create or enhance a separate and distinct asset should be capitalized under I.R.C. § 263; it does not mean that only expenditures that create or enhance a specific asset are to be capitalized. The Court determined that while "the mere presence of an incidental future benefit . . . may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." The Court found a significant long-term effect for the taxpayer, indicating that expenses incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary expenses.

Subsequent courts have nonetheless noted, and in fact the INDOPCO opinion acknowledged, that the decisive distinctions between current expenses and capital expenditures are those of degree and not kind, and that the mere presence of "some future aspect" may not warrant capitalization. INDOPCO v. Commissioner, 503 U.S. 79, 86 (1992). See also Metrocorp., Inc. v. Commissioner, 166 T.C. 211, 222 (2001); Connecticut Mutual Life Insurance Co. v. Commissioner, 106 T.C. 445, 453 (1996). The relevant inquiry therefore does not end at whether the taxpayer realized benefits beyond the year in which the expenditure occurred, but requires additional query into the duration and extent of those benefits. See, e.g., Black Hills Corp. v. Commissioner, 73 F.3d 799, 806 (8th Cir. 1996).

In Norwest Corp. v. Commissioner, 112 T.C. 89, 99 (1999), which involved investigatory costs in a friendly merger, the court acknowledged the "longstanding rule" that expenses directly incurred in reorganizing or restructuring are not deductible under § 162. Quoting from INDOPCO, the court explained that the purpose behind such expenses "has to do with the corporation's operations and betterment . . . for the duration of its existence or for the indefinite future or for a time somewhat longer than the current year."

In examining the nature of the $[redacted] fee, we believe that it provided substantial benefits well beyond the year paid. The payment was made for the purpose of allowing the taxpayer to enter into a merger agreement with a third party. Because the taxpayer had a contract with [redacted], it had to purchase its release from that contract in order to reorganize in the fashion it determined was most desirable, i.e., its merger with [redacted]. Furthermore, we believe that such fee may be characterized as directly incurred in reorganizing or restructuring. On [redacted], the taxpayer's Board decided to reorganize in the manner set forth in the [redacted] offer. As a consequence of this decision, the taxpayer had to break its prior agreement with [redacted], since it of course could not complete both transactions. In other words, payment of the $[redacted] to [redacted] flowed as a natural and legal consequence of the taxpayer's agreement with [redacted]. We therefore believe that the $[redacted] fee was directly incurred in the taxpayer's reorganization, and is therefore not deductible under § 162.

Even if, however, such fee were not a direct expense, the Service should be sufficiently able to demonstrate a substantial long-term benefit so as to deny the taxpayer's claimed deduction of the $[redacted] fee. In Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974), the taxpayer paid $100,000.00 to release itself from its grant of exclusive territorial rights to a third party. The reason for such termination was the perceived underperforming of the third party's business ventures related to his territorial rights. The court found that the taxpayer's payment to release itself from this agreement was capital in nature, since the taxpayer acquired a valuable right from which it could anticipate earning profits over future years. Similarly in the present case, the taxpayer's Board believed that its business opportunities would be enhanced (i.e., it could enter into a better deal with [redacted] if it bought itself out of the [redacted] deal. We nonetheless believe that the length and extent of the benefit should be a secondary position, and that the Service's primary argument should be that the fee was necessarily incurred in connection with its agreement with [redacted].

2. [redacted] , , (b)(7)a, (b)(5)(AC), (b)(5)(AWP) [redacted]

[redacted]

(b)(7)a, (b)(5)(AC), (b)(5)(AWP)

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please note that we consider the opinions expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow for appropriate National Office review. If you have any questions regarding the above, please contact me at (602) 207-8052.

JOHN W. DUNCAN
Attorney